The Aerial View
Market Update

ZAR Update

• The ZAR has been an outlier among the 'fragile five' of late

• A range of issues pose the risk of the currency's continued slide

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South African President Ramaphosa has wasted little time implementing some of the reforms promised in last month’s election campaign, but the ZAR has taken little note. In fact, unlike its fellow ‘fragile five’ currencies (with average gains of 1.3%), it has been unable to capitalise on the USD’s fortnight-long slump.

That the ZAR’s 0.7% losses have also defied a surge in the price of gold (with which it has held a 65% correlation since 2010) speaks of a currency struggling with a crisis of confidence.

Then again, the South African economy was ill-prepared for a year of international trade turmoil which has culminated in the country’s worst economic slump in a decade (after growth of just 0.8% last year). Driven by manufacturing and mining, GDP fell by 3.2% q/q in Q1 – almost double the drop expected – and SARB’s 1.3% growth forecast for the year looks to be in trouble.

A 4.6% annual increase in industrial production in April constitutes a small silver lining, but the slump in GDP has focused the market’s mind on the government’s limited scope for a fiscal response, in addition to the further damage that weak growth will inflict upon the country’s longer-term potential.
A slowing economy can only hasten what has been a steady ascent towards a 30% unemployment rate over the past ten years; and such deep-seated economic malaise hardly bodes well for a turn-around in the country’s poor track record in investment. Indeed, gross fixed capital formation fell by 4.5%, and for a fifth consecutive quarter, in Q1.

Yet South Africa’s structural problems go beyond investment outlay and are typified by the Eskom crisis. Falling behind schedule and over budget on construction of two large coal-fired generating plants has left the state-owned power utility bloated with debt and stricken with high operating costs.

Scheduled blackouts were implemented as a result, something that undoubtedly contributed to the collapse in Q1 GDP; but the growing concern is the likely impact on public finances of attempts to ensure the company’s solvency. The National Treasury had already forecast a 4.5% fiscal deficit for 2019 before the startling Q1 GDP report came to light, and coupled with Eskom’s tribulations, this projection could yet prove to be somewhat conservative.

Moody’s for one is conscious of growing fiscal risks. The only major agency that rates the country’s sovereign debt above junk (at Baa3) holds out little hope for any successful and timely stimulus. It has noted that “any fiscal stimulus would likely come with immediate or nearly immediate costs, but potential economic benefits that would take longer to accrue”.

There can be little wonder then that foreign investors dumped South African bonds en masse last Friday; but to cap off the evident problems such risks pose to the ZAR at current levels, the ruling ANC is also in the midst of a squabble over the SARB’s mandate, with one faction in the party promoting a more active role in demand-management for the central bank.

In the very short-term at least, this might prove academic. Even before last week’s GDP report, two of SARB’s five MPC officials favoured a cut in interest rates; but our suspicion is that committee members already have a good idea what the bank’s quarterly projection model will tell them by the time of the next SARB policy meeting on July 18.

All in all, the risks of the ZAR’s continued descent against the USD are far from immaterial.

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